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CRIMINAL PROSECUTIONS UNDER THE INVESTMENT COMPANY ACT OF 1940 AND THE INVESTMENT ADVISERS ACT

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Although the law relating to investment companies has developed substantially during the past decade,¹ little has been written concerning the criminal provisions of the Investment Company Act of 1940² (1940 Act) and its companion statute, the Investment Advisers Act³ (Advisers Act). The absence of scholarly analysis regarding the criminal sanctions in these statutes perhaps is attributable to the paucity of prosecutions sought under either law.⁴ However, the recent decision of the Second Circuit Court of Appeals in *United States v. Deutsch*,⁵ the first criminal action to be brought under the "self-dealing" proscriptions of the 1940 Act,⁶ has generated a renewed interest in the criminal provisions of that Act.

This article examines the specific criminal provisions of both the 1940 Act and the Advisers Act and analyzes the prosecutions brought under each statute. Primary emphasis will be placed on the *Deutsch* court's interpretation of Section 17(e)(1) of the 1940 Act. In addition, the article will discuss the ambiguity existing in the criminal provisions of both statutes, in light of the proposed revision of these laws under the Proposed Federal Criminal Code.⁷ It is the conclusion of this author that the *Deutsch* court's broad interpretation of the 1940 Act will serve to ease the government's burden of proof in actions brought under the Act and thereby increase the statute's deterrent effect.

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¹ See generally Investment Company Amendments Act of 1970, Pub. L. No. 91-547, Dec. 14, 1970. See also Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 1-37 (1962); SEC Institutional Investor Study, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971).

² 15 U.S.C. §§ 80a-1 et seq. (1970).

³ 15 U.S.C. §§ 80b-1 et seq. (1970).

⁴ Apparently there have been only nine prosecutions under the 1940 Act and the Advisers Act. See notes 25-34 and accompanying text *infra*.

⁵ 451 F.2d 98 (2d Cir. 1971), cert. denied, — U.S. —, 92 S. Ct. 682 (1972).

⁶ 15 U.S.C. § 80a-17(e)(1) (1970).

⁷ Final Report of the National Commission on Reform of Federal Criminal Laws, A Proposed New Federal Criminal Code, (1971).

I. GENERAL BACKGROUND

The Securities and Exchange Commission (SEC) administers six separate federal statutes, all containing criminal provisions: the Securities Act of 1933 (1933 Act),⁸ the Securities Exchange Act of 1934 (1934 Act),⁹ the Public Utility Holding Company Act of 1935 (1935 Act),¹⁰ the Trust Indenture Act of 1939 (1939 Act),¹¹ the Investment Company Act of 1940, and the Investment Advisers Act. Unlike the Mail Fraud¹² and Wire Fraud¹³ statutes, the securities statutes generally do not designate specific acts as crimes. Instead, they contain "penalty" provisions¹⁴ which encompass, with one exception,¹⁵ three operative sections: (a) a general proscription which makes the willful violation of any substantive provision of the statute, or any rule or regulation promulgated thereunder, a crime; (b) a specific proscription which renders certain willful false filings made pursuant to the statute criminal acts; and (c) a provision which prescribes maximum penalties to be imposed upon conviction. The criminal sanctions of both the 1940 Act and the Advisers Act are patterned after the more familiar criminal provisions of the 1933 and 1934 Acts.¹⁶

⁸ 15 U.S.C. §§ 77a et seq. (1970).

⁹ 15 U.S.C. §§ 78a et seq. (1970).

¹⁰ 15 U.S.C. §§ 79 et seq. (1970).

¹¹ 15 U.S.C. §§ 77aaa et seq. (1970).

¹² 18 U.S.C. § 1341 (1970).

¹³ 18 U.S.C. § 1343 (1970).

¹⁴ 15 U.S.C. §§ 77x (1933 Act), 78ff(a) (1934 Act), 79z-3 (1935 Act), 77yyy (1939 Act), 80a-48 (1940 Act), 80b-17 (Advisers Act) (1970).

¹⁵ The "penalties" provision of the Advisers Act, 15 U.S.C. § 80b-17 (1970), does not contain a clause relating to specific false filings, as do the other statutes. However, false filings under that Act may still be prosecuted under the general proscription making the willful violation of a substantive filing provision a crime, or under the Federal False Statements Statute, 18 U.S.C. § 1001 (1970). For instance, false filings under the 1934 Act are sometimes prosecuted under 18 U.S.C. § 1001 (1970). See, e.g., *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), cert. denied, 397 U.S. 1006 (1970).

¹⁶ Thus § 49 of the 1940 Act labelled "penalties" provides:

Any person who willfully violates any provision of this subchapter or of any rule, regulation, or order hereunder, or any person who willfully in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this subchapter or the keeping of which is required pursuant to section 80a-30(a) of this title makes any untrue statement of a material fact or omits to state any material fact necessary in order to prevent the statements made therein from being materially misleading in the light of the circumstances under which they were made, shall upon conviction be fined not more than \$10,000 or imprisoned not more than two years, or both; but no person shall be convicted under this section for the violation of any rule, regulation, or order if he proves that he had no actual knowledge of such rule, regulation, or order.

15 U.S.C. § 80a-48 (1970). In addition, § 37 of the 1940 Act, labelled "larceny and embezzlement," states:

Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the moneys, funds,

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The SEC has brought civil and administrative actions under all the statutes;¹⁷ however, the Commission itself does not directly conduct criminal prosecutions under any of the securities laws since the Department of Justice has sole jurisdiction over the conduct of all such prosecutions.¹⁸ In practice, the SEC staff initially conducts either a formal or informal investigation,¹⁹ and where criminal prosecution appears warranted, it prepares a Criminal Reference Report.²⁰ Pursuant to the statutes, the Commission then transmits the Criminal Reference Report, accompanied by any evidence that it has gathered, to the Attorney General of the United States who, in his discretion, may institute the necessary criminal proceedings.²¹ The Department of Justice then refers the case to a local United States Attorney's Office which, with the assistance of SEC staff members, presents the case to a grand jury and conducts the ultimate trial of any indictment returned.

Prior to the mid-1930's, the Department of Justice prosecuted securities crimes primarily under the Federal Mail Fraud Statute.²²

securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 80a-48 of this title. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts.

15 U.S.C. § 80a-36 (1970). Furthermore, § 217 of the Advisers Act, provides:

Any person who willfully violates any provision of this subchapter, or any rule, regulation, or order promulgated by the Commission under authority thereof, shall, upon conviction, be fined not more than \$10,000, imprisoned for not more than two years, or both.

15 U.S.C. § 80b-17 (1970).

¹⁷ The right of SEC staff attorneys to litigate civil injunctive actions initiated by the Commission was specifically upheld in *SEC v. Robert Collier & Co.*, 76 F.2d 939 (2d Cir. 1935).

¹⁸ Thus, although many of the underlying facts and charges in both the civil and criminal actions in the "Fifth Avenue Coach Lines" cases were similar, the SEC staff conducted the civil injunctive trial, *SEC v. Fifth Avenue Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), aff'd, 435 F.2d 510 (2d Cir. 1970), while the Office of the U.S. Attorney for the Southern District of New York conducted the parallel criminal litigation, *United States v. Cohn*, SEC Litigation Release No. 5194 (S.D.N.Y. 1971). In practice, SEC staff attorneys usually assist local U.S. Attorneys at each stage of a criminal prosecution. Mathews, *Criminal Prosecution Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 Geo. Wash. L. Rev. 901, 913-20 (1971). [hereinafter cited as Mathews].

¹⁹ See, e.g., Mathews, *Witnesses in SEC Investigations: A Primer for Witnesses and their Counsel on the Scope of the SEC's Investigatory Power*, 3 Rev. of Sec. Reg. No. 9 (May 5, 1970).

²⁰ Mathews, *supra* note 18, at 914-18.

²¹ 15 U.S.C. § 77t(b) (1970). The comparable provision in the 1940 Act is 15 U.S.C. § 80a-41(e) (1970), and, in the Advisers Act, 15 U.S.C. § 80b-9(e) (1970).

²² 18 U.S.C. § 1341 (1970). See, e.g., *United States v. Brown*, 79 F.2d 321 (2d Cir. 1935), cert. denied sub nom. *McCarthy v. United States*, 296 U.S. 650 (1935); *United States v. Brown*, 5 F. Supp. 81 (S.D.N.Y. 1933); *Van Riper v. United States*, 13 F.2d 961 (2d Cir. 1926), cert. denied sub nom. *Ackerson v. United States*, 273 U.S. 702 (1926). See

Thereafter, securities prosecutions were also brought under the 1933 and 1934 Acts.²³ Even after passage of both the 1940 Act and the Advisers Act, the Justice Department continued to bring the majority of investment company or adviser-related criminal cases under the antifraud provisions of the 1933 Act and the 1934 Act.²⁴

It appears that only four criminal prosecutions have been sought under the Advisers Act²⁵ and in each of these actions the defendants

also Ashby, Federal Regulation of Securities Sales, 22 Ill. L. Rev. 635 (1928). In some cases the Federal Wire Fraud Statute was also used, 18 U.S.C. § 1343 (1970).

²³ Mathews, *supra* note 18, at 907-13. See, e.g., *United States v. Kelly*, 349 F.2d 720 (2d Cir. 1965), cert. denied, 384 U.S. 947 (1966), for a recent 1933 Act prosecution. In *United States v. Wolfson*, 289 F. Supp. 903 (S.D.N.Y. 1968), rev'd, 437 F.2d 862 (2d Cir. 1970) the government charged 1934 Act crimes, whereas in *United States v. Sampson*, 371 U.S. 75 (1962), criminal violation of the Mail Fraud Statute was alleged.

²⁴ In the 1933 Act the antifraud provision is § 17(a), 15 U.S.C. § 77q(a) (1970); in the 1940 Act it is § 10b, 15 U.S.C. § 78j(b) (1970), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1971). For a recent prosecution of an investment adviser under § 17(a) of the 1933 Act, see *United States v. Van Allen*, 30 SEC Ann. Rep. 133-34 (S.D.N.Y. 1964), convictions aff'd in part and rev'd in part sub nom. *United States v. Kelly*, 349 F.2d 720 (2d Cir. 1965), cert. denied, 384 U.S. 947 (1966). For investment company prosecutions under the 1933 and 1934 Acts see *Burns v. United States*, 286 F.2d 152 (10th Cir. 1961) and *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953).

²⁵ To the writer's knowledge, the first indictment containing a specific charge of a substantive Advisers Act crime was in *United States v. Hageman*, SEC Litigation Release Nos. 670 (July 25, 1951), 789 (May 7, 1953) and 791 (May 5, 1953), where two corporations and the defendant Hageman were indicted on charges of mail fraud and violation of the antifraud provisions of § 206 of the Advisers Act, 15 U.S.C. 80b-6 (1970). No trial was ever held in the case, since the defendants all pleaded guilty to the indictment. The first actual trial of a substantive Advisers Act crime apparently was held in 1960-1961 in *United States v. Greenman*, SEC Litigation Release Nos. 1835A (Nov. 18, 1960) and 1879 (Jan. 9, 1961) (D. Utah). Greenman, a registered broker-dealer and investment adviser doing business as "Western Trader & Investor," was indicted on various fraud counts under the 1933 and 1934 Acts as well as under § 206 of the Advisers Act. His indictment was based upon alleged activities encompassing the sale of worthless personal securities to discretionary and advisory clients, and the misappropriation of clients' funds and securities to finance his personal securities transactions. After full trial, Greenman was acquitted of every crime charged in the indictment. *Id.*

In *United States v. Todd*, SEC Litigation Release Nos. 1838 (Nov. 17, 1960) and 1845 (Nov. 28, 1960), the defendant, a registered investment adviser doing business as "The New England Counsellor," was charged with violating the "anti-touting" provisions of § 17(b) of the 1933 Act and the antifraud provisions of § 206 of the Advisers Act. The indictment charged that Todd assisted others in accomplishing a fraudulent distribution of unregistered stock by recommending that stock to his clients without disclosing that he had received compensation from the issuer and certain underwriters and dealers to make such recommendations. It was further charged that Todd failed to disclose that he recommended the stock in order to create a demand for it and raise its price in order to facilitate distribution. Todd pleaded *nolo contendere* to the charges. *Id.* The case is a landmark since it resulted in the first criminal conviction under the anti-touting provisions of § 17(b) of the 1933 Act, 15 U.S.C. § 77q(b) (1970).

In *United States v. Seybold*, SEC Litigation Release Nos. 2061 (July 18, 1961), 2125 (Oct. 19, 1961) and 2206 (March 7, 1962) the defendant, a registered investment adviser doing business as "Seybold and McBurney," was indicted for violations of § 206 of the Advisers Act, § 17(a) of the 1933 Act and the Mail Fraud Statute. The indictment charged,

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were charged with violating the antifraud provisions of the Act.²⁶ Three of the four cases never reached trial because the defendants entered pleas of guilty or *nolo contendere*.²⁷ In the fourth,²⁸ the accused, after trial, was acquitted of all charges.²⁹ Since there are no appellate opinions concerning Advisers Act prosecutions, little can be said about judicial interpretation of the statute's criminal provisions. Nor can much be learned from an examination of trial records, since the last case involving a criminal violation of the Advisers Act was litigated over ten years ago.³⁰ Prior to *United States v. Deutsch*, no case involving violations of the 1940 Act had reached appeal.³¹ Of the four prosecutions brought under this Act,³² only one³³ resulted in a full jury trial.³⁴

inter alia, that the defendant had gained the trust and confidence of clients of the firm, including persons inexperienced in securities matters, had obtained possession of and sold certain of their securities, and had converted the proceeds to his own benefit. It was further alleged that the defendant illegally pledged securities belonging to clients as collateral for personal loans, and deposited various sums of money in clients' bank accounts, falsely representing to them that the funds were derived from interest or dividends collected on their securities when in fact such securities had been sold and the defendant had appropriated the proceeds to his own use. Seybold pleaded guilty to every count in the indictment. Id.

²⁶ Section 206 of the Advisers Act, under which the charges were brought, provides: "It shall be unlawful for any investment adviser by use of the mails . . . to employ any device . . . to defraud any client. . . ." 15 U.S.C. § 80b-6 (1970).

²⁷ See note 25 supra.

²⁸ *United States v. Greenman*, SEC Litigation Release Nos. 1834A (Nov. 18, 1960) and 1879 (Jan. 9, 1961) (D. Utah).

²⁹ Id.

³⁰ *United States v. Seybold*, SEC Litigation Release Nos. 2061 (July 18, 1961), 2125 (Oct. 19, 1961) and 2206 (March 7, 1962).

³¹ Judge Timbers, writing the opinion in *Deutsch*, stated that the court was faced with a question of first impression. 451 F.2d 98, 102 (2d Cir. 1971).

³² Not until 1960, 20 years after enactment of the 1940 Act, was the first indictment returned specifically alleging criminal violations of substantive provisions of that Act. *United States v. Crosby*, SEC Litigation Release No. 1825 (Nov. 1, 1960) (S.D.N.Y.). In that case defendant Francis Peter Crosby had acquired control of Jefferson Research Foundation, Inc., and through that entity gained control of Jefferson Custodian Fund, Inc., a registered investment company. He then liquidated portfolio securities, converted the cash proceeds to his own use and attempted to sell worthless securities to the fund. Crosby pleaded guilty to criminal violations of the self-dealing proscriptions of § 17(a)(1) of the 1940 Act, 15 U.S.C. § 80a-17(a)(1) (1970), to conspiracy, 18 U.S.C. § 371 (1970), and to Rule 10b-5 crimes. 17 C.F.R. § 240.10b-5 (1971).

In 1966, in *United States v. Weiner*, SEC Litigation Release No. 3460 (March 17, 1966), the former secretary of Revere Fund, Inc., was charged with violations of the anti-embezzlement and larceny provisions of § 37 of the 1940 Act. The information alleged that Weiner had embezzled certain assets of the Fund, and had transmitted a materially false and misleading letter to the Commission regarding his activities. This was the first time that a § 37 crime had ever been charged in an SEC criminal prosecution. A trial was never held, since Weiner pleaded *nolo contendere* to the charges. Id.

Also in 1966, in *United States v. Jacobs*, SEC Litigation Release No. 3568 (Aug. 19, 1966), defendant Jacobs, the former president of Continental Growth Fund, was indicted for violation of § 37. It was alleged that he misappropriated funds from the Fund's share-

There appear to be several reasons why the Justice Department has sought so few criminal prosecutions under either the 1940 Act or the Advisers Act. First, the SEC has never structured a concerted criminal enforcement program under either statute. In fact, enforcement of the Advisers Act, even in civil and administrative actions, has always been sporadic and lax in comparison to the Commission's intensive enforcement program under the 1933 and 1934 Acts. The SEC's Division of Trading and Markets and the various Regional and Branch Offices have committed only limited resources to enforcement of the 1940 Act and the Advisers Act. This reluctance to engage in a more active enforcement program appears to be grounded in the belief that the criminal activities of a registered investment adviser are more successfully dealt with by resorting to the antifraud provisions of the 1933 and 1934 Acts.

Second, since criminal prosecution of an investment adviser or an investment company manager is likely to encompass fraud in the purchase or sale of securities, most prosecutors prefer to base an indictment upon the antifraud provisions of Section 17(a) of the 1933 Act, or upon Section 10(b) of the 1934 Act and Rule 10b-5 thereunder, because of the substantial body of case law interpreting those acts.³⁵ By proceeding under these statutes, the government can argue issues such as burden of proof and applicable defenses with more certainty. On the other hand, the law relating to both the 1940 Act and the Advisers Act has not been developed and is subject to varying interpretations by the SEC, the Justice Department and the courts.³⁶

Finally, although the SEC Division of Corporate Regulation does have a small, active branch carrying out a 1940 Act enforcement program, this program has always been directed primarily at the administrative level. Criminal prosecutions, as the small number of cases indicates, have been almost nonexistent, and even civil injunctions are seldom sought. In light of this dearth of litigated criminal cases under the 1940 Act, the decision in *United States v. Deutsch* takes on added

holders through a series of sham transactions. He was also indicted for conspiring with a broker-dealer to defraud the Fund by causing it to purchase worthless securities. The indictment was never tried. *Id.*

³³ *United States v. Burdick*, SEC Litigation Release Nos. 4512 (Nov. 6, 1968), 4180 (Dec. 10, 1968).

³⁴ In *Burdick*, the defendant, a sales representative and divisional manager of Waddell & Reed, Inc., the investment adviser and underwriter of United Funds, Inc. (a registered investment company), was convicted of violating the self-dealing and larceny provisions of the 1940 Act. *Id.*

³⁵ See Mathews, *supra* note 18, at 907-13.

³⁶ See, e.g., *SEC v. Talley Indus., Inc.*, 399 F.2d 396, 405-06 (2d Cir. 1968), where the court noted that § 17(d) of the 1940 Act had rarely been construed.

significance because of its almost unique precedential value in future interpretation of the 1940 Act.

II. THE DECISION IN *United States v. Deutsch*

A. *The Factual Background*

In 1967 Jerome Deutsch, an executive of Realty Equities, a real estate investment company, was given the responsibility of raising \$12 million in capital for the company through a private placement of units of promissory notes.³⁷ Deutsch's initial efforts to sell the issue met with failure; only after making contact with Frank D. Mills, an investment adviser to a number of mutual funds, was Deutsch able to sell a unit of notes to Puritan Fund.³⁸ Thereafter, because of Puritan's prestigious name and influence in the industry, the remainder of the \$12 million issue was easily sold.³⁹ Somewhat later, in October, 1968, Deutsch negotiated a "private deal" with Mills by which Mills was able to obtain a unit of notes from Realty Equities at a price substantially below its market value at that time.⁴⁰ Shortly after that purchase, Mills advised Fidelity Trend Fund to buy a unit from Realty Equities at a price nearly double that which Mills had paid. At trial the government contended that Mills was accorded a bargain purchase because of his past services in promoting the Puritan Fund purchase and his contemplated future services in effecting the Fidelity Trend Fund sale.⁴¹

In an attempt to conceal their private deal, Mills and Deutsch refrained from requesting SEC approval, set up nominee accounts with the banks through which the purchase was consummated and gave false and misleading evidence to the SEC in its investigation.⁴² Mills was indicted⁴³ for violations of Sections 17(d)⁴⁴ and (e)(1)⁴⁵ of the

³⁷ Each unit consisted of a \$500,000, 7½%, 15-year promissory note, a warrant for the purchase of 37,500 shares of Realty stock at a gradually ascending price, and the right to use the note in lieu of cash when exercising the warrant. The purchase price of the unit was the face amount of the note. The initial exercise price of the warrant was the market price of Realty stock on the day before the first closing. 451 F.2d 98, 103-04 (2d Cir. 1971).

³⁸ Mills was a senior officer of Fidelity Management and Research Company in Boston and an investment adviser to twelve affiliated mutual funds, including Puritan Fund and Fidelity Trend Fund. Id. at 104.

³⁹ In fact, an additional \$5 million of units was subsequently authorized for private sale, and fully sold by June, 1968. Puritan Fund purchased \$700,000 of the additional units. Id.

⁴⁰ Mills obtained a unit for \$537,000 on October 21, 1968, while Fidelity Trend Fund paid \$928,125 per unit for two units on October 24. Id. at 106.

⁴¹ Id. at 114-15.

⁴² Id. at 106-07.

⁴³ Id. at 103. The indictment contained seven counts. Counts One and Two alleged that Mills had violated § 17(d) by knowingly effecting purchases of securities for his personal account and for the accounts of Puritan Fund and Fidelity Trend Fund, without

1940 Act. The former prohibits joint ventures between investment companies and their affiliates without prior Commission approval; the latter bars persons affiliated with investment companies from receiving compensation in transactions in which they act as agents for the companies. Deutsch was similarly indicted for aiding and abetting the 1940 Act crimes under the federal "aiding and abetting" statute.⁴⁶ Prior to trial Mills pleaded guilty to the 17(d) charge and his case was severed from the *Deutsch* prosecution. After Deutsch was convicted of aiding

filing the required application and without obtaining SEC approval. Prior to trial, Mills entered a plea of guilty to the 17(d) violation.

Counts Three and Four charged Deutsch with aiding and abetting Mills' § 17(d) crimes. Count Five charged Mills with violating § 17(e)(1) by knowingly accepting compensation from Realty Equities while acting as an agent for the purchase of the securities for the investment companies.

Count Six charged Deutsch with aiding and abetting Mills' § 17(e)(1) crime. Finally, Count Seven charged Mills and Deutsch with a criminal violation of Rule 10b-5, for making false statements and material omissions in connection with their sales of securities to the funds.

After Mills had pleaded guilty to Count One, he was severed from the trial of Deutsch and did not testify for either side at Deutsch's trial. Prior to the trial, the government consented to the dismissal of Count Seven against both Mills and Deutsch. Counts Three and Four against Deutsch were dismissed during the trial at the close of the government's case. After the jury convicted Deutsch on Count Six for aiding and abetting the 17(e)(1) crime, Counts Two and Five against Mills were dismissed with consent of the government. *Id.* at 102-03.

⁴⁴ Section 17(d) of the 1940 Act, 15 U.S.C. § 80a-17(d) (1970) provides:

It shall be unlawful for any affiliated person of . . . a registered investment company . . . acting as principal to effect any transaction in which such registered company . . . is a joint or a joint and several participant with such person . . . in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered . . . company on a basis different from or less advantageous than that of such other participant.

Id.

Rule 17d-1, 17 C.F.R. § 270.17d-1 (1971), provides that an affiliated person of a registered investment company cannot act as principal in effecting any transaction in connection with any joint enterprise in which the investment company is a participant without in advance filing an application with the Commission in order to obtain Commission approval of the transaction.

⁴⁵ Section 17(e) of the 1940 Act, 15 U.S.C. § 80a-17(e) (1970), provides:

It shall be unlawful for any affiliated person of a registered investment company . . . (1) acting as agent, to accept from any source any compensation . . . for the purchase or sale of any property to or for such registered company

The section goes on to state that if the affiliated person *acts as a broker* he may receive compensation equivalent to a usual and customary broker's commission in the transaction. *Id.*

⁴⁶ 18 U.S.C. § 2 (1970) provides:

(a) Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.

(b) Whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.

and abetting the 17(e)(1) crime, the government dismissed the 17(e)(1) charge against Mills.⁴⁷

B. *Interpreting Section 17(e)(1):
"Acting as Agent"*

The jury found on the facts presented at Deutsch's trial that Mills, as an affiliated person of Puritan Fund and Fidelity Trend Fund, while "acting as agent" had unlawfully accepted compensation for the purchase or sale of any property to or for the registered companies.⁴⁸ At trial, Deutsch did not dispute the facts that Mills was an affiliated person of both Puritan Fund and Fidelity Trend Fund, that both Funds were registered investment companies, or that Mills was not acting as a broker in the transactions. However, Deutsch did argue that the phrase "acting as agent" in the statute "[made] the violation proscribed by section 17(e)(1) incomplete unless the compensation *actually* caused a fund to purchase or sell securities."⁴⁹ He further argued that there was no proof that the bargain sale to Mills had actually caused Puritan Fund or Fidelity Trend Fund to purchase the Realty Equities units.

The trial court rejected Deutsch's proposed rigid construction of section 17(e)(1), and adopted, instead, the government's contention that the section would be violated if compensation were paid to an agent who *potentially* could influence the fund's decision to buy or sell the securities in question, even though there was no proof that such potential influence was actually exercised. The trial judge thus instructed the jury that:

The Government does not have to show that Mills was influenced by the compensation he received or that as a result of receiving it Mills caused either of the funds to purchase the notes or influenced others in either of the funds to make such purchase.

. . .

You may find that he acted as an agent if you determine that he *had the power* to make investment decisions for Puritan Fund at the time of its purchases or that as a result of his position in the company he could influence the decisions regarding the purchases by Fidelity Trend of Realty Equities notes.⁵⁰

On appeal of Deutsch's conviction, the Second Circuit Court of

⁴⁷ 451 F.2d at 103.

⁴⁸ Id. at 109, 119.

⁴⁹ Id. at 109 (emphasis added).

⁵⁰ Id. (emphasis added).

Appeals was faced with a question of first impression in attempting to resolve whether under section 17(e)(1) "it is an element of the offense that the recipient of the compensation take any action as a result thereof," and thus, whether use of the verb "acting" in the statutory phrase "acting as agent" was meant to connote "a Congressional intent to prohibit only gratuities which succeed in influencing the recipient's conduct."⁵¹ Writing for the court, Judge Timbers, a former General Counsel of the SEC, noted that no court in a civil or criminal case had ever discussed the intent of Congress in enacting section 17(e)(1). He further noted that there was no helpful legislative history specifically dealing with that provision.⁵² The court, however, did find guidance in general legislative history declaring the policies and purposes underlying passage, as a whole, of the 1940 Act:

The Senate and House Reports indicate that the Act was designed primarily to correct the abuses of self-dealing which had produced injury to stockholders of investment companies. Four sections of the Act, including Section 17, were aimed specifically at insuring the independence of management and its fidelity to stockholders. Congress recognized that its existing laws were inadequate to prevent the abuses of self-dealing. Several times during the hearings, Senators questioned SEC attorneys on their inability to obtain convictions, thus evincing a concern about the difficulties of obtaining convictions for abuse of trust in the investment company industry. . . . The Act was thus designed in part quite clearly to establish broad standards which would more easily enable the Government to convict affiliated persons for self-dealing in the management of investment companies—an industry the very nature of which made it particularly difficult to gather proof.⁵³

⁵¹ *Id.*

⁵² Although acknowledging that § 17(e)(1) had been considered in civil court cases, Judge Timbers found no prior "attempt to unravel" the proper meaning of § 17(e)(1). *Id.* at 107-08.

⁵³ *Id.* at 108. The court also found guidance in the following recent SEC administrative disciplinary opinions: Bernard Cornfeld, SEC Securities Exchange Act Release No. 9094 (March 1, 1971); Provident Management Corp., SEC Securities Exchange Act Release No. 9028 (Dec. 1, 1970); Dishy, Easton and Co., SEC Securities Exchange Act Release No. 8702 (Sept. 23, 1969); Consumer-Investor Planning Corp., SEC Securities Exchange Act Release No. 8542 (Feb. 20, 1969); and Imperial Financial Services, Inc., SEC Securities Exchange Act Release No. 7684 (Aug. 26, 1965). 451 F.2d at 109-10. It should be noted that these administrative cases were settled through negotiation prior to trial. In the author's opinion, the precedential value of opinions in administrative cases settled by consent is tenuous. The very willingness of the parties in such proceedings to forego the opportunity to research and submit arguments based upon the applicable facts and law deprives the proceeding of the quality of deliberation and consideration which might elevate the consent judgment to precedent. One cannot ignore the extent to which extra-legal considerations may motivate many parties to give up the fight and consent.

In light of the import of this general legislative history, the Second Circuit rejected Deutsch's contentions and construed section 17 (e)(1) in a manner even broader than that of the trial court. The court stated:

We find it hard to believe . . . that a Congress which had recognized that the investment company industry "offer[ed] manifold opportunities for exploitation by unscrupulous managements" . . . meant that an offense was complete only when the affiliated person acted as a result of receiving something of value. Rather, we believe that the more reasonable interpretation is that an offense under § 17 (e)(1) is complete when the compensation is delivered and received with the forbidden intent *The abuse which § 17(e)(1) was designed to prevent—affiliated persons operating under conflicts of interest—was complete when Mills received the compensation, even if he never exerted any influence on Realty's behalf.*⁵⁴

Accordingly, the court found that as soon as Mills purchased the Realty note at a reduced price, he was inhibited by a conflict of interest that might becloud his judgment, to the detriment of the funds' shareholders. This was, the court stated, the very type of conflict of interest which the statute was intended to proscribe. As a result, no actual proof of impairment or actual damage to a fund and/or its shareholders was required.⁵⁵

The result of the court's broad construction of the statute is that "an affiliated person is acting as agent within the meaning of section 17(e)(1) in all cases when he is not acting as broker for the investment company," and that the proscriptions of the subsection apply even to affiliated persons *who do not have the capacity to influence investment decisions.*⁵⁶ Thus an affiliated person acting as broker can accept only the equivalent of the usual and customary brokerage commissions in connection with the purchase or sale of securities for the fund; an affiliated person not acting as broker, even if he is not in a position to influence the fund's investment decisions, can accept no consideration whatsoever in connection with the fund's purchase or sale of securities.⁵⁷

⁵⁴ Id. at 109 (emphasis added).

⁵⁵ Id. at 109-10. The court cited cases showing that the payment of the gratuity was sufficient to sustain the violation. See *United States v. Irwin*, 354 F.2d 192 (2d Cir. 1965), cert. denied, 383 U.S. 967 (1966) and *Howard v. United States*, 345 F.2d 126 (1st Cir.), cert. denied, 382 U.S. 838 (1965).

⁵⁶ 451 F. 2d at 111.

⁵⁷ Id. at 110-11.

C. *Requisite Criminal Intent Under
Section 17(e)(1)*

As indicated by the Second Circuit, section 17(e)(1) is violated only if the compensation is accepted "with the forbidden intent."⁵⁸ However, what constitutes "intent" under the securities laws is not clear. Since 1933, various courts have struggled with the particular nature of criminal intent required to sustain convictions under myriad provisions of the federal securities laws. The nature of the particular intent required varies from statute to statute, and, indeed, among various provisions of any one of the statutes.⁵⁹

Deutsch argued that the requisite criminal intent to support a section 17(e)(1) crime was proof "that the compensation was given with the intent to influence."⁶⁰ Indeed, the trial judge had charged the jury that, in order to convict, it must find that the compensation *was given and received* with the intent to influence Mills.⁶¹ However, the Second Circuit chose to interpret section 17(e)(1) in a manner consistent with analogous federal "gratuity statutes" and held that there is no requirement to show an "intent to influence."⁶² The court stated:

The paying of compensation is an evil in itself, even though the payor does not corruptly intend to influence the affiliated person's acts, for it tends to bring about preferential treatment in favor of the payor which can easily injure the beneficiaries of investment companies. Congress recognized that affiliated persons had manifold opportunities for self-dealing and designed a statute to remove the potential for conflicts of interest by prohibiting the receipt of compensation "for the purchase or sale of any property . . ." We hold that to read into § 17(e)(1) a requirement of intent to influence would frustrate this statutory purpose.⁶³

The *Deutsch* opinion makes it clear, therefore, that as in the case of other federal "gratuity statutes," the only proof of criminal intent required to sustain a conviction under section 17(e)(1) is proof of an "intent to give and accept a gratuity in appreciation of past or future conduct."⁶⁴ Applying this test to the facts which the jury rea-

⁵⁸ Id. at 109.

⁵⁹ Mathews, *supra* note 18, at 950-59.

⁶⁰ 451 F.2d at 112.

⁶¹ The trial judge had charged the jury that it "must determine whether or not the compensation was accepted for the purchase of securities by either Puritan Fund in February or June or by Fidelity Trend Fund in October." Id. at 112 n.18.

⁶² Id. at 112-13.

⁶³ Id.

⁶⁴ Id.

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sonably could have found based on evidence presented at trial, the court found sufficient proof of requisite criminal intent and sustained Deutsch's conviction.⁶⁵

The *Deutsch* court's broad interpretation of Section 17(e)(1) of the 1940 Act is a clear indication that the court will scrutinize those actions of investment company managers or advisers which might lead to conflicts of interest. The meaning which the court has given to the phrases "acting as agent" and "criminal intent" should warn potential violators of the criminal liability for transactions involving conflicts of interest. Certainly, the court's holding will ease the government's burden of proof in future prosecutions. Rather than having to prove an intent to influence, the prosecution will merely have to show that an illegal transaction occurred. Consequently, *Deutsch* is likely to increase the deterrent effect of both the 1940 Act and the Advisers Act.

III. RULE VIOLATIONS: MISDEMEANOR VERSUS FELONY TREATMENT

One area of conflict which has never been resolved by litigation is the status of *rule* violations under the 1940 and Advisers Acts. It is clear that a *statutory* violation of either act constitutes a felony. Section 49 of the 1940 Act and Section 217 of the Advisers Act provide that willful violation of those statutes may be punished by a fine of not more than \$10,000 and/or imprisonment of not more than two years.⁶⁶ Since the maximum term of imprisonment that can be imposed exceeds one year, a 1940 Act or Advisers Act crime is automatically a felony, even though no prison term may actually be imposed.⁶⁷ Ignorance of the law is not a defense; competent persons are presumed to know the law pertaining to their conduct and are charged with a duty to obey it. Thus a claim of lack of knowledge of a particular statutory proscription would not constitute a valid defense to a felony conviction under either act.⁶⁸

⁶⁵ Id. at 113. In affirming Deutsch's conviction, the court rejected several other proffered defenses: (1) that § 17(e)(1) is so vague as to be void under the due process clause of the Fifth Amendment; (2) that the evidence was insufficient to prove the statutory element of compensation; (3) that the trial court's admission of Mills' statements regarding the 17(d) crime was contrary to the hearsay rule and deprived Deutsch of his Sixth Amendment right to confrontation; (4) that Deutsch was denied a fair trial as a result of certain remarks made by the trial judge and the prosecutor regarding the failure of Mills to appear as a witness at the trial; (5) that the prosecutor's summation improperly contained misstatements of law and inflammatory remarks; and (6) that Deutsch could not be convicted of aiding the 17(e)(1) crime if Mills had not been convicted of the violation of 17(e)(1). Id. at 113-18.

⁶⁶ 15 U.S.C. §§ 80a-48, 80b-17 (1970).

⁶⁷ 18 U.S.C. § 1(1) (1970).

⁶⁸ See, e.g., *American Surety Co. v. Sullivan*, 7 F.2d 605, 606 (2d Cir. 1925); see also Mathews, *supra* note 18, at 950-51.

Rule violations, however, are treated differently. Section 49 of the 1940 Act provides that violations of *rules* or *regulations* promulgated under that Act do not constitute crimes if lack of knowledge of the rule is proven.⁶⁹ Conversely, if actual knowledge of a rule is proven, violation would be both criminal and felonious.⁷⁰ There is no intermediate provision in the 1940 Act, as there is in the 1934 Act, where a "no-knowledge" rule violation can constitute a misdemeanor.⁷¹ By way of comparison, the Advisers Act contains neither a "no-knowledge" misdemeanor provision nor a provision like Section 49 of the 1940 Act stating that a rule violation, without actual knowledge, does not create criminal liability. Rather, Section 217 of the Advisers Act provides that any person who "willfully" violates a rule is guilty of a felony.⁷²

It is clear from opinions in criminal cases brought under other federal securities statutes that "knowledge" connotes more of a consciousness of guilt than "willfulness"; a "person can willfully violate an SEC rule even if he does not know of its existence."⁷³ It has been held that the word "willful," even in criminal statutes, "means no more than that the person charged with the duty knows what he is doing. It does not mean that, in addition, he must suppose that he is breaking the law."⁷⁴ Conversely, "knowledge," while not requiring actual awareness of the specific language or number of a statutory provision or rule, does require awareness of the "standards" contained in the provision or rule. To prove lack of knowledge under the federal securities laws, there must be sufficient evidence showing ignorance of the substance of the rule.⁷⁵ Since willfulness and knowledge are separate and distinct concepts,⁷⁶ lack of knowledge probably would not be a defense to a felony conviction for an Advisers Act rule vio-

⁶⁹ Section 49 provides that "no person shall be convicted under this section for the violation of any rule, regulation, or order if he proves that he had no actual knowledge of such rule, regulation, or order." 15 U.S.C. § 80a-48 (1970).

⁷⁰ Since a rule violation with knowledge is a willful violation, it is criminal under § 49. Because § 49 further states that such a crime is punishable by two years' imprisonment, it is thus a felony. 15 U.S.C. § 80a-48 (1970).

⁷¹ There has been a flurry of recent litigation involving construction of the "no-knowledge" misdemeanor treatment of rule violations under § 32(a) of the 1934 Act, 15 U.S.C. § 78ff(a) (1970). See, e.g., *United States v. Peltz*, 433 F.2d 48 (2d Cir. 1970); *United States v. Mandel*, 296 F. Supp. 1038 (S.D.N.Y. 1969); and *United States v. Lilley*, 291 F. Supp. 989 (S.D. Tex. 1968).

⁷² 15 U.S.C. § 80b-17 (1970).

⁷³ *United States v. Peltz*, 433 F.2d 48, 54-55 (2d Cir. 1970); see also Herlands, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 Va. L. Rev. 139, 145-49 (1934).

⁷⁴ *American Surety Co. v. Sullivan*, 7 F.2d 605, 606 (2d Cir. 1925).

⁷⁵ *United States v. Lilley*, 291 F. Supp. 989, 993 (S.D. Tex. 1968).

⁷⁶ See Mathews, *Criminal Prosecutions under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 Geo. Wash. L. Rev. 901, 950-51 (1971).

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lation. However, no case brought under the Advisers Act has addressed this issue.

There is no apparent reason, nor any legislative history, justifying or explaining why the "no-knowledge" rule violations are treated differently in criminal prosecutions under the various securities statutes. Perhaps this inconsistency was a result of legislative oversight. Whatever the reason, it is submitted that the criminal provisions of the different securities laws regarding felony or misdemeanor treatment should be harmonized.

IV. PROPOSED FEDERAL CRIMINAL CODE

There is an effort under way in both the executive and legislative branches of the federal government to supplant the various criminal provisions contained in Title 18 of the U.S. Code and the myriad other federal statutes with a modern, uniform Federal Criminal Code. In January, 1971, the National Commission on Reform of Federal Criminal Laws published a Final Report which contained its version of a Proposed Federal Criminal Code.⁷⁷ The proposal, which is presently under consideration by the Senate Subcommittee On Criminal Laws and Procedures, contains provisions which substantially alter the criminal sanctions presently imposed by the 1940 and Advisers Acts.⁷⁸

One apparent weakness of the proposed Code is that sufficient consultation was not made with attorneys having securities law expertise and others functioning in the securities markets as to their view of the effect of the Code on existing provisions of the federal securities laws. The recommendations of the National Commission concerning 1940 Act and Advisers Act crimes are particularly objectionable. That Commission has recommended that all federal crimes, including violations of the securities laws, be classified into six categories, in descending order of seriousness: Class A, B and C felonies; Class A and B misdemeanors; and petty "infractions." Felony Classes A, B and C would carry maximum sentence terms of thirty, fifteen and seven years, respectively. Misdemeanor Classes A and B would carry maximum terms of one year and thirty days, respectively.⁷⁹ Under present law, all 1940 Act crimes are felonies carrying a maximum prison term of two years and/or a maximum fine of \$10,000. However, under the National Commission's Proposed Code, 1940 Act and Advisers Act crimes would never be felonies, but instead would constitute Class A

⁷⁷ Final Report of The National Commission on Reform of Federal Criminal Laws, A Proposed New Federal Criminal Code (1971) [hereinafter cited as Final Report].

⁷⁸ Id. § 1772. Hearings on Reform of the Federal Criminal Laws Before the Subcomm. on Criminal Laws and Procedures of the Senate Comm. on the Judiciary, 92d Cong., 1st Sess. (1971).

⁷⁹ Final Report, *supra* note 77, §§ 3002, 3201.

misdeemeanors carrying a maximum one year term of imprisonment and a maximum fine of \$1,000.⁸⁰

It is submitted that adoption of these changes in the criminal penalties under the 1940 and Advisers Acts would dangerously dilute the prophylactic effect of the statutes, and, as such, would be detrimental to the public interest. Historically, investment advisers have been held to the strictest fiduciary standard in their relationships with investment companies. Therefore, criminal penalties for unlawful acts arising from this relationship should be severe, not minor. If the National Commission's proposals are enacted, the maximum punishment which could be imposed for 1940 Act criminal violations, such as the self-dealing situation which occurred in *Deutsch*, would be less severe, economically, than the administrative sanctions that the SEC or self-regulatory bodies such as the National Association of Securities Dealers (NASD) or the New York Stock Exchange could impose for the same violation.⁸¹

At the very least, crimes under the 1940 Act and the Advisers Act based on fraud or self-dealing, or any false filings pursuant to the applicable filing provisions of those acts, should be treated as Class C felonies, bearing a maximum sentence, under the present range proposed, of seven years imprisonment and/or a fine of \$5,000.⁸² Such Class C felony treatment has already been applied to registration and antifraud crimes under the 1933 Act, manipulation and antifraud crimes under the 1934 Act and Rule 10b-5 thereunder, and false statement crimes under the 1933 and 1939 Acts.⁸³ No persuasive reasons have been offered as to why similar criminal violations under the 1940 Act and the Advisers Act should not also be accorded felony treatment. At a time in our history when institutionalization of the securities markets is rapidly increasing, and when millions of public investors are entrusting more and more of their savings to investment company managers and investment advisers, enlightened public policy demands that criminal breaches of trust and other criminal abuses committed by such fiduciaries be subject to penalties more, not less, severe than those presently applicable.

Finally, it is suggested that a fuller consideration be given to the

⁸⁰ Id. § 1772, Comment at 239; §§ 3201(1)(d), 3301(1)(c).

⁸¹ The NYSE Constitution provides for fines of up to \$25,000 for an individual member and \$100,000 for a member firm or member corporation in lieu of suspension or expulsion. NYSE Constitution, Art. XIV, § 13, 2 CCH NYSE Guide ¶ 1663 at 1087-1088 (1971); The NASD Rules of Fair Practice provide for a fine of up to \$5,000. NASD Rules of Fair Practice, Art. V, § 1, CCH NASD Manual ¶ 2301 (1971).

⁸² Final Report, *supra* note 77, §§ 3002, 3201(1)(c), 3301(1)(b). In fact, in the writer's opinion, all the proposed maximum fines contained in the Proposed Code should be increased substantially.

⁸³ Id. § 1772.

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effects of the proposed changes on the securities laws. Attorneys with securities law expertise should be consulted as to any revisions. In this way changes can be made which will standardize the existing inconsistent criminal provisions contained in the securities statutes; at the same time, expert opinions can be given concerning the severity of penalties which should be imposed by each law.

CONCLUSION

The fact that few prosecutions have been sought under the 1940 Act, and its companion statute, the Advisers Act, should not be viewed as evidence that the criminal provisions under those Acts are ineffective. Rather, it would appear that the deterrent effect of such criminal provisions, coupled with the close regulation of investment companies by the SEC, has in recent years severely curtailed criminal transgressions by investment company managers and/or investment advisers. After *Deutsch*, the deterrent effect of such provisions probably will be even greater.

Notwithstanding the success of the *Deutsch* prosecution, it can be expected that, absent passage of a new, comprehensive criminal code, securities law prosecutions involving investment advisers and/or investment company managers or affiliated persons will continue to be brought primarily under the criminal provisions of the 1933 and 1934 Acts and the Federal Mail Fraud Statute, because of the familiarity which prosecutors have with these laws. Advisers and 1940 Acts prosecutions will probably continue to be infrequent because of the more technical nature of those statutes and the unfamiliarity of most prosecutors. However, in the 1940 Act prosecutions that are in fact brought, the *Deutsch* decision will probably ease the government's burden in obtaining convictions by encouraging courts to construe 1940 Act provisions flexibly. In this way, the courts can achieve the dominant statutory purpose of the Investment Company Act by attempting to provide investor protection through the elimination of investment managers' conflicts of interest. Finally, it is suggested that the Proposed Federal Criminal Code be modified to make statutory violations of the 1940 Act and the Advisers Act Class C felonies, with strict maximum penalties of seven years imprisonment and/or a \$5,000 fine. These revisions would insure close regulation of investment company managers and advisers and would maximize investor protection.